

Alert 10-186

## North Carolina Creates New Tax Incentive Opportunity for Digital Media Companies

On July 22, 2010, North Carolina Governor Beverly Purdue signed into law legislation that creates a new and innovative tax credit for companies developing interactive digital media, including video game companies and developers of online virtual worlds and interactive websites that allow consumers to create and manipulate certain digital goods (i.e., avatars in role-playing scenarios).

### WHAT THIS MEANS

Interactive digital media developers that are currently located in North Carolina—as well as those contemplating doing business in North Carolina—should evaluate their business activities to take full advantage of the tax benefits of this tax incentive credit when it becomes effective next year. Specifically, we encourage companies to consider joint ventures with educational institutions for the purpose of maximizing the benefits provided by the North Carolina credit.

Effective January 1, 2011, House Bill 1973 (Session Law 2010-147) ("H.B. 1973") provides:

- A tax credit of 15 percent on expenses related to the development of interactive digital media. Interactive digital media includes material produced for electronic distribution, such as material that is intended for distribution through electronic download over the Internet that both (1) contains a computer-controlled universe in which the user interacts for an intended goal, and (2) contains animation, sound, text, fixed images or 3D geometry.<sup>1</sup> The tax credit may be applied against either franchise or income tax; however, the election is binding.<sup>2</sup>
- Specific expenses against which the credit may be taken, which include: (1) compensation and wages paid to full-time employees; (2) amounts made in contribution to health, pension, and welfare accounts by employees; and (3) amounts paid to North Carolina community colleges and universities for services performed in the state.<sup>3</sup> Notably, the credit increases to 20 percent on the development costs incurred for work performed by community colleges and universities located in North Carolina.<sup>4</sup>

### Implications for Educational Institutions

North Carolina is currently home to a multitude of interactive media companies, including Electronic Arts, Epic Games, Red Storm and Atomic Games. While the credit created under H.B. 1973 is presumably aimed at retaining and growing these existing industries—and attracting new ones—to the state, it goes further than similar legislation recently enacted in Florida, Georgia, Louisiana and Virginia by providing for a higher tax credit for development expenses paid to North Carolina schools.<sup>5</sup>

- The education partnership component of the North Carolina incentive creates a unique opportunity for the digital companies to undertake joint ventures with nonprofit universities that may, depending on how and for what purpose they are structured, even qualify for additional state or federal tax credit programs. As an example, a video gaming company might form a joint venture to develop a new line of interactive online games with a community college located in a rural community, with the venture being housed in a certified LEED facility. A host of potential state and federal credits could apply to such a venture (i.e., R&D, LEED, Empowerment and Zone credits).
- The potential for tax credits may also give the video gaming companies an opportunity to form venture partnerships apart from their usual "norms." For example, a video game company may form a joint venture with a university to develop an online, interactive game that would create "shaping" exercises for the benefit of autistic children. Such a venture could qualify not only for the digital interactive media credit on development expenses (i.e., wages), but also for other state and federal tax credits that do not apply to compensation expenses.

### Limits

Certain restrictions apply to the new interactive digital media credit. The credit is allowed against the percentage of the taxpayer's expenses that exceed \$50,000 and cannot exceed \$7.5 million.<sup>6</sup> In addition, certain prohibited classes of interactive digital media (i.e., casino gaming, company advertisements, political advertisements, and obscene materials) are excluded from the credit.<sup>7</sup>

## WHY THIS MATTERS

With North Carolina's tax credit for interactive digital media providers becoming effective January 1, 2011, companies that are currently eligible or who would like to become eligible to take this credit should contact Reed Smith now to discuss how to best position themselves to take full advantage of this incentive program. For more information on North Carolina's new credit incentives for interactive digital media, and how companies might think about using this new credit to form joint ventures, please contact the author of this Alert, or the Reed Smith attorney with whom you regularly work.

1. N.C. Session Law 2010-147, Part III, section 3.6 (G.S. § 1095-129.56).
2. G.S. § 105-129.52(a).
3. G.S. § 105-129.56(b).
4. G.S. § 105-129.56(c).
5. See S1752: Relating to Economic Development (approved by governor; Ch. 2010-47 on May 28, 2010) (Florida); HB 1100 – Income tax credit; qualified film, video, or digital productions (signed into law May 12, 2008; Art. 2, O.C.G.A. Ch. 7, Tit. 48) (Georgia); Louisiana Acts 2005, No. 346, § 1, eff. June 30, 2005 (Louisiana); VA House Bill 861/Senate Bill 257 (signed into law April 11, 2010, Va. Code 58.1-439.12:03, eff. Jan. 1., 2013) (Virginia).
6. G.S. § 105-129.56(b).
7. G.S. § 105-129.56(d).

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